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FUTURE YEARS DEFENSE PROGRAM

Lower Inflation Outlook Was Most Significant Change From 1996 to 1997 Program





United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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The Honorable John R. Kasich
Chairman, Committee on the Budget
House of Representatives

The Honorable Charles E. Grassley
The Honorable William V. Roth, Jr.
United States Senate

At your request, we compared the Department of Defense's (DOD) fiscal year 1997 Future Years Defense Program (FYDP) with the FYDP for fiscal year 1996. Specifically, we determined (1) the impact of the reduction in the inflation rate on DOD's 1997 FYDP, (2) the major program adjustments from the 1996 FYDP to the 1997 FYDP, and (3) the implications of these changes for the future.

Background

In 1995, we compared the 4 common years (1996-99) in DOD's 1995 and 1996 FYDPs and reported that DOD projected substantial shifts in funding priorities.¹ Specifically, about \$27 billion in planned weapon system modernization programs had been eliminated, reduced, or deferred to 2000 or later. Also, the military personnel, operation and maintenance, and family housing accounts had increased by over \$21 billion and were projected to continue to increase to 2001 to support DOD's emphasis on readiness and quality-of-life programs. Moreover, the total DOD program was projected to increase by about \$12.6 billion.

The Secretary of Defense wants to reform the acquisition process and reduce and streamline infrastructure to help pay the billions of dollars that DOD projects it will need to modernize the force. In our September 1995 report, we said that although DOD anticipated reducing infrastructure to achieve substantial savings, our analysis of the 1996 FYDP showed that savings accrued or expected to accrue from base closures and a smaller force appeared to be offset by increased funding for other infrastructure priorities, such as base operations and management headquarters. In May 1996, we analyzed the infrastructure portion of DOD's 1997 FYDP and

¹Future Years Defense Program: 1996 Program Is Considerably Different From the 1995 Program (GAO/NSIAD-95-213, Sept. 15, 1995).

reported that infrastructure costs are projected to increase by about \$9 billion, from \$146 billion in 1997 to \$155 billion in 2001.²

The FYDP includes anticipated future inflation. Therefore, changes in anticipated inflation affect the projected cost of the FYDP. The Secretary of Defense testified in March 1996 that the 1997 FYDP, which covers fiscal years 1997-2001, includes the funds to buy all of the programs in the 1996 FYDP plus billions of dollars in additional programs at less cost overall. According to DOD, the increase in programs at lower projected costs results because inflation estimates were substantially reduced for future DOD purchases, from 3 percent to about 2.2 percent for fiscal years 1997-2001.

Results in Brief

As a result of projecting significantly lower inflation rates, DOD calculated that its future purchases of goods and services in its 1997 FYDP would cost about \$34.7 billion less than planned 1 year ago in its 1996 FYDP. According to DOD, the assumed increased purchasing power that resulted from using the lower inflation rates (1) allowed DOD to include about \$19.5 billion in additional programs in fiscal years 1997-2001 than it had projected in the 1996 FYDP and (2) permitted the executive branch to reduce DOD's projected funding over the 1997-2001 period by about \$15.2 billion.

The price measure the executive branch used in its inflation projections for future purchases in the 1997 FYDP had inherent limitations and has since been improved. If the executive branch decides to use the improved price measure to price its 1998 budget, DOD may need to adjust its program as a result of that transition. Office of Management and Budget (OMB) officials told us they have not decided what price measure they will use to forecast inflation for the 1998 FYDP. Using projected inflation rates based on a different price measure from that used by the executive branch, the Congressional Budget Office (CBO) estimated that the future cost of DOD's purchases through 2001 would decline by only about \$10.3 billion, or \$24.4 billion less than DOD's estimate.

Resource allocations in the 1997 FYDP vary considerably from the 1996 FYDP as a result of the lower inflation projections, program transfers, and program changes. For example, (1) the procurement accounts decreased about \$26 billion from the 1996 FYDP to the 1997 FYDP—including about \$15.3 billion due to lower projected inflation rates and about \$10.4 billion

²Defense Infrastructure: Costs Projected to Increase Between 1997 and 2001 (GAO/NSIAD-96-174, May 31, 1996).

from program transfers to research, development, test, and evaluation accounts; (2) the operation and maintenance accounts decreased by about \$10 billion due to lower projected inflation rates; and (3) the research, development, test, and evaluation accounts increased by \$11 billion primarily due to transfers from the procurement accounts and program changes.

The projected savings from the latest round of base closures and realignments changed considerably from the 1996 FYDP to the 1997 FYDP. In the 1996 FYDP, DOD estimated savings of \$4 billion from base closures; however, the 1997 FYDP projects savings of only \$0.6 billion. This is because (1) the 1996 FYDP projected savings based on interim base closing plans that subsequently changed and (2) military construction costs related to environmental cleanup of closed bases are projected to be \$2.5 billion higher than anticipated in the 1996 FYDP.

A comparison of the 1996 and 1997 FYDPs also shows that DOD plans to reduce active duty force levels. The smaller force planned for fiscal years 1998-2001 would bring force levels below the minimum numbers established by law. If DOD is precluded from carrying out its plan to achieve a smaller force, it will have to make other adjustments to its program.

1997 FYDP Reflects Increased Purchasing Power Due to Lower Projected Inflation

The executive branch substantially reduced its forecast of the inflation rate for fiscal years 1997 through 2002, resulting in a decline in the estimated costs of DOD's purchases of about \$45.7 billion, including about \$34.7 billion over the 1997-2001 FYDP period.³ However, the price measure used in the executive branch's projections had inherent limitations and has since been improved. Using a different price measure, CBO projected a much smaller drop in inflation and estimated that the future cost of DOD's purchases would be reduced by only about \$10.3 billion over the 1997-2001 period.

Lowered Inflation Forecast Yields Projected \$35 Billion Increase in Purchasing Power in 1997 FYDP

The executive branch reduced its inflation forecasts from 3 percent per year for the period 1997-2001 to 2.2 percent per year, or 8/10 of 1 percent.⁴ As a result, DOD projected that the cost of defense purchases would decline by \$34.7 billion for the 1997-2001 period and an additional \$11 billion for

³DOD's nonpay and nonfuel purchases subject to this lower inflation rate range from about \$138 billion to about \$166 billion for fiscal years 1997-2001, over 50 percent of DOD's budget.

⁴Inflation was forecast at 2.2 percent for all years except 1999, for which the forecast was 2.3 percent.

2002. Based on these projected cost reductions, the executive branch reduced DOD's projected budgets for fiscal years 1997-2001 by about \$15.2 billion. The executive branch allowed DOD to retain about \$19.5 billion of the projected increase in purchasing power. The distribution of this assumed additional purchasing power was \$4.3 billion in 1997, \$3.9 billion in 1998, \$4.6 billion in 1999, \$3.8 billion in 2000, and \$2.9 billion in 2001.

According to DOD, about \$6 billion of the \$19.5 billion was applied to the military personnel and operation and maintenance accounts for must-pay bills such as for the military retired pay accrual and ongoing contingency operations. The remaining \$13 billion was applied primarily to DOD's modernization priorities. Funding was allocated to purchase trucks and other support equipment, accelerate the acquisition of next generation systems, upgrade existing systems, and fund Army base closure costs. A detailed list of these planned purchases is provided in appendix I.

Change to Inflation Forecasting Has Implications for 1998 FYDP

For more than a decade, OMB has used projections of the Commerce Department's Bureau of Economic Analysis' (BEA) implicit price deflator for gross domestic product (GDP) based on a "fixed-weighted" methodology to adjust the future costs of defense nonpay purchases other than fuel. According to OMB officials, anecdotal information for recent years suggests that changes in this measure have been an accurate gauge of inflation in DOD purchases. The fixed-weighted methodology was used to prepare the President's fiscal years 1996 and 1997 budgets.

Economists within the government and in private organizations generally recognize that the implicit price deflator based on a fixed-weighted methodology has inherent limitations, in part because it is derived from the values of goods and services based on a fixed base year such as 1987. This fixed-weighted methodology has in recent years tended to overstate economic growth and understate inflation as time progressed beyond the base year. Because of the limitations in the fixed-weighted methodology, BEA switched to a new "chain-weighted" inflation methodology, just after the President's fiscal year 1997 budget had been prepared in January 1996. The "chain-weighted" methodology, which is continuously updated by using weights for 2 adjacent years, ensures that differences in relative prices, such as the drop in computer prices, will not distort overall GDP statistics. Economists have maintained that this methodology is superior to the fixed-weighted methodology. According to BEA officials, the improved methodology gives a more accurate measure of inflation

because it eliminates the potential for cumulative errors under the old (fixed-weighted) methodology.⁵ For the 1997-2001 period, the executive branch projected an annual inflation rate of 2.2 percent as measured by the fixed-weighted methodology and 2.7 percent as measured by the chain-weighted methodology.

In discussing the transition from the GDP implicit price deflator based on fixed weights to the chain-weighted GDP price deflator, OMB officials stated that the two differing numerical measures represent the same inflation, in the same economy, at the same time. According to the officials, the difference is “precisely analogous” to measuring the same temperature on Celsius or Fahrenheit scales. The only difference between the two measures is the methodology used. However, as a practical matter, OMB provides DOD a specific numerical index of inflation, and DOD applies this index to estimate future funding requirements. Therefore, the index used has a direct impact on DOD’s estimated future funding requirements. For example, our analysis shows that had DOD applied the new chain-weighted inflation assumption of 2.7 percent to develop its 1997-2001 FYDP rather than the fixed-weighted assumption of 2.2 percent, DOD’s increased purchasing power would be only about \$12.7 billion, not \$34.7 billion.

OMB officials told us they have not decided what methodology they will use to project inflation for the next FYDP, which will encompass the 1998-2003 defense program. However, in commenting on a draft of this report, DOD said that OMB has indicated its intention to adopt the chain-weighted methodology for budgeting beginning with the fiscal year 1998 submission. In addition, the President’s budget for fiscal year 1997 emphasized the limitations of the fixed-weighted methodology and featured the improved chain-weighted methodology in presenting economic assumptions for the future. If OMB uses the improved chain-weighted methodology to provide inflation guidance to DOD, DOD’s funding estimates for fiscal years 1998 and beyond could be affected. For example, on a chain-weighted basis, two major private forecasting firms currently project an inflation rate of about 2.5 percent per year over the next 5 years, which is a decline from the 2.7 percent chain-weighted inflation assumption that appears in the fiscal year 1997 budget. If OMB gives DOD an inflation projection of 2.5 percent per year for the 1998-2003 period, a question arises as to whether such a factor will be interpreted as an increase (from the 2.2 percent as measured by the fixed-weighted methodology) or a decrease (from the 2.7 percent as

⁵For a more complete discussion of the transition from the fixed-weighted methodology to the chain-weighted methodology, see the Budget of the United States Government, Analytical Perspectives for Fiscal Year 1997, page 6. For a more precise definition of these terms, see The Economic and Budget Outlook: An Update (The Congressional Budget Office, Aug. 1996).

measured using the chain-weighted methodology.) Without further guidance, DOD may increase its estimates of future funding requirements for inflation when inflation is projected to be lower than the earlier forecast.

CBO Forecasted an Increase in DOD Purchasing Power of \$10.3 Billion in the 1997 FYDP

During consideration of the fiscal year 1997 defense budget, the Chairman of the Senate Committee on the Budget requested that CBO estimate the adjustments that should be made to DOD's budget estimates through 2002 that would keep its purchasing power constant given lower inflation rates. CBO chose not to use the implicit price deflator for GDP based on the fixed-weighted methodology that OMB had used to calculate inflation because it had been replaced by the new chain-weighted methodology. Instead, CBO based its inflation forecast on the Consumer Price Index, which measures changes in the average cost of a fixed market basket of consumer goods and services because that measure had not been revised. Neither the executive branch's nor CBO's estimate presumes any ability to forecast prices of goods and services purchased by DOD. Instead, the two estimates calculate the change in a general index of inflation and assume that prices of defense goods and services would change by the same amount.

Using the Consumer Price Index, CBO projected a much smaller decrease in inflation between the 2 budget years than the executive branch did. Whereas the executive branch projected an 8/10 of 1 percent drop in inflation, CBO projected that inflation would drop only 2/10 of 1 percent. As a result, CBO projected that DOD's purchasing power would increase by only about \$10.3 billion for the 1997-2001 period. This estimate is about \$24.4 billion less than DOD's estimated \$34.7 billion increase. Further, because the executive branch reduced DOD's estimated 1997-2001 FYDP by about \$15.2 billion, CBO's estimate indicates that DOD's real purchasing power was reduced by about \$5 billion. In action on the fiscal year 1997 budget resolution, the Senate adjusted defense totals downward to reflect CBO's more conservative estimate. The House did not make any adjustments for lower inflation. The conference agreement on the budget resolution recommended the Senate level for fiscal year 1997 and levels somewhat closer to the House amounts in later years.

Major Resource Shifts From the 1996 FYDP to the 1997 FYDP

Our analysis shows that resource allocations in the 1997 FYDP vary considerably from the 1996 FYDP. These resource adjustments result primarily from inflation adjustments and transfers between accounts.

Table 1 shows a year-to-year comparison of DOD's 1996 and 1997 FYDPs by primary accounts.

Table 1: Comparison of DOD's 1996 and 1997 FYDPs by Primary Accounts

Dollars in billions

Account	FYDP	Fiscal year					Total
		1997	1998	1999	2000	2001	
Military personnel	FY 1996	\$67.5	\$68.2	\$69.6	\$70.9	\$72.3	\$348.5
	FY 1997	69.8	69.2	70.0	71.1	73.1	353.2
	Increase	2.3	1.0	0.4	0.2	0.8	4.7
Operation and maintenance	FY 1996	90.6	89.9	92.7	94.8	98.1	466.1
	FY 1997	89.1	88.6	90.1	92.3	95.9	456.0
	Decrease	-1.5	-1.3	-2.6	-2.5	-2.2	-10.1
Procurement	FY 1996	43.5	51.4	54.2	62.3	67.3	278.7
	FY 1997	38.9	45.5	50.5	57.7	60.1	252.7
	Decrease	-4.6	-5.9	-3.7	-4.6	-7.2	-26.0
Research, development, test, and evaluation	FY 1996	32.7	31.7	30.9	30.2	30.6	156.1
	FY 1997	34.7	35.0	33.7	31.9	31.7	167.0
	Increase	2.0	3.3	2.8	1.7	1.1	10.9
Military construction	FY 1996	5.1	4.6	4.4	3.8	3.9	21.8
	FY 1997	5.5	4.8	4.7	4.1	4.2	23.3
	Increase	0.4	0.2	0.3	0.3	0.3	1.5
Family housing	FY 1996	4.5	4.1	4.4	4.5	4.6	22.1
	FY 1997	4.0	3.8	4.1	4.1	4.1	20.1
	Decrease	-0.5	-0.3	-0.3	-0.4	-0.5	-2.0
Revolving funds and undistributed contingencies	FY 1996	0.6	0.9	1.0	0.6	0.8	3.9
	FY 1997	1.9	2.1	1.9	1.5	1.5	8.9
	Increase	1.3	1.2	0.9	0.9	0.7	5.0
Total	FY 1996	\$244.4	\$250.8	\$257.3	\$267.1	\$277.5	\$1,297.1
	FY 1997	\$244.0	\$249.0	\$255.1	\$262.5	\$270.4	\$1,281.0
	Decrease	-\$0.4	-\$1.8	-\$2.2	-\$4.6	-\$7.1	-\$16.1

Note: Program estimates in DOD's FYDP are expressed in total obligational authority (TOA). TOA is the sum of new budget authority provided for a given fiscal year and any other amounts authorized to be credited to a specific fund or account during that year, including transfers between funds or accounts. TOA may not reflect exactly the budget authority adjustments made in the President's budget. Table totals may not add due to rounding.

Source: Fiscal years 1996 and 1997 FYDPs.

The following sections discuss some of the more significant changes in each of the primary accounts.

Military Personnel

Overall, funding for military personnel accounts increased by \$4.7 billion for the 1997-2001 period, although DOD plans to reduce the number of military personnel below the levels reflected in last year's FYDP. The increase primarily reflects (1) higher pay raises for fiscal years 2000 and 2001 than were included in the 1996 FYDP and (2) the transfer of U.S. Transportation Command costs from a revolving fund supported mainly by operation and maintenance accounts to the military personnel accounts.

Programs that are expected to receive the largest funding increases are Army divisions (\$1.5 billion) and Army force-related training (\$1.6 billion). Other programs are projected to be reduced. Some of the largest declines are projected for Army National Guard support forces (\$2.6 billion), Army Reserve readiness support (\$1.6 billion), and Air Force permanent change-of-station travel (\$650 million).

The 1997 FYDP shows that DOD plans to lower active duty force levels in fiscal years 1998-2001. The planned smaller force would bring force levels below the permanent end strength levels set forth in the National Defense Authorization Act for fiscal year 1996 (P.L. 104-106). Table 2 shows the minimum force levels in the law and DOD's planned reductions.

Table 2: Required Force Levels and DOD Planned Reductions

Service	Required levels	Planned FY 2001 force levels	Planned reductions 1998-2001
Army	495,000	475,000	-20,000
Navy	395,000	394,000	-1,000
Marine Corps	174,000	174,000	0
Air Force	381,000	375,000	-6,000
Total	1,445,000	1,418,000	-27,000

Source: National Defense Authorization Act for fiscal year 1996 and the 1997 FYDP.

The Commission on Roles and Missions recommended that DOD perform a quadrennial review to assess DOD's active and reserve force structure, modernization plans, infrastructure, and other elements of the defense program and policies to help determine the defense strategy through 2005. The National Defense Authorization Act for fiscal year 1997 directed the Secretary of Defense to conduct the review in fiscal year 1997. Congress

will have an opportunity to examine the assessment and recommendations of the review. The act also requires the Secretary of Defense to include in the annual budget request funding sufficient to maintain its prescribed permanent active end strengths.⁶ If DOD is precluded from implementing its planned personnel reductions, it will have to make other compensating adjustments to its overall program.

Operation and Maintenance

The operation and maintenance accounts are projected to decrease by about \$10.1 billion during the 1997-2001 period due to lower inflation rates. In addition, there were a number of funding reallocations among operation and maintenance programs from the 1996 FYDP to the 1997 FYDP. Programs that are projected to receive the largest gains include Army real property services (\$3.9 billion), real property services training (\$1.1 billion), and Navy administrative management headquarters (\$1.5 billion). Programs that are projected to decrease the most include Navy servicewide support (\$2.1 billion); defense health programs, including medical centers, station hospitals, and medical clinics in the United States (\$2.3 billion); Army National Guard reserve readiness support (\$1.4 billion); Army base operations (\$4.2 billion); DOD environmental restoration activities (\$1.3 billion); and DOD's Washington headquarters services (\$1 billion).

Projected savings from the latest round of base closures are also less than were anticipated in the 1996 FYDP. The 1996 FYDP projected savings of \$4 billion during 1997-2001 from the fourth round of base closures beginning in fiscal year 1996. The 1997 FYDP projects total savings of \$0.6 billion, \$3.4 billion less than the 1996 FYDP projection. The decrease in savings is primarily due to higher than anticipated base closure-related military construction costs for environmental cleanup activities in fiscal year 1997.

Typically, the planned costs to conduct contingency operations have not been included in DOD's budget submission. However, given that forces are deployed in Bosnia and Southwest Asia and these known expenses will continue into fiscal year 1997, DOD included \$542 million for the Bosnian operations and \$590 million for Southwest Asian operations in the President's fiscal year 1997 budget. The Bosnian estimate was later revised to \$725 million, and DOD has informally advised the Senate and House Committees on Appropriations of this increase. Most of these funds are in operation and maintenance accounts.

⁶The 1996 act authorized a 0.5-percent flexibility in meeting permanent end strength levels. This was increased to 1 percent in fiscal year 1997.

Procurement

The procurement accounts are projected to decrease by about \$26 billion during the 1997-2001 period. About \$15.3 billion of the reduction can be attributed to the use of the lower inflation rate. A comparison of the 1996 and 1997 FYDPS indicates that about \$10.4 billion of the \$26 billion reduction is due to a transfer of intelligence and classified program funding from the procurement accounts to classified research, development, test, and evaluation accounts. According to DOD officials, the programs are more accurately classified as research, development, test, and evaluation than procurement. The comparison also shows that DOD eliminated a \$5.4-billion program in the procurement accounts that was called “modernization reserve” in the 1996 FYDP. According to DOD officials, this funding was redistributed among procurement programs.

The 1997 FYDP continues the downward adjustments in the procurement accounts, which we first identified in our September 1995 report on the fiscal years 1995 and 1996 FYDPS. We reported that the fiscal year 1995 FYDP, which was the first FYDP to reflect the bottom-up review strategy, reflected relatively high funding levels for procurement of weapon systems and other military equipment. The funding level for procurement was estimated to be \$60 billion by fiscal year 1999. Since the 1995 FYDP, DOD has steadily reduced programmed funding levels for procurement in favor of short-term readiness, quality-of-life improvements, research and development, and infrastructure activities. DOD now projects that the procurement account will not contain \$60 billion until 2001. Table 3 shows DOD’s planned procurement reductions.

Table 3: Reductions in Planned Procurement Programs Since the 1995 FYDP

Dollars in billions

FYDP	Fiscal year							Total
	1995	1996	1997	1998	1999	2000	2001	
FY 1995	\$43.3	\$48.4	\$49.8	\$57.1	\$60.1	^a	^a	
FY 1996	44.8	39.4	43.5	51.4	54.2	\$62.3	\$67.3	
Change	1.5	-9.0	-6.3	-5.7	-5.9	^a	^a	
FY 1997	43.2	43.4	38.9	45.5	50.5	57.7	60.1	
Change	-1.6	4.0	-4.6	-5.9	-3.7	-4.6	-7.2	
Cumulative reduction	-\$0.1	-\$5.0	-\$10.9	-\$11.6	-\$9.6	-\$4.6	-\$7.2	-\$49.0

^aNot available.

Source: Fiscal years 1995, 1996, and 1997 FYDPS.

In addition to the \$10-billion transfer of intelligence and classified programs, significant planned decreases in funding and quantities of items include \$2 billion for 1 Navy amphibious assault ship (LHD-1) and \$1.1 billion for 240 theater high-altitude area defense systems. Funding levels for some programs were increased in the 1997 FYDP over last year's plan. For example, \$1.5 billion was added in the 1997 FYDP for 172 Army UH-60 Blackhawk helicopters, and \$4 billion for 2 new SSN submarines.

The National Defense Authorization Act for fiscal year 1997 authorized the addition of about \$6.3 billion more than the President's budget request for procurement. Programs receiving significant increases include the new SSN submarine; DDG-51 destroyer; the E-8B, C-130, V-22, and Kiowa warrior aircraft; and the Ballistic Missile Defense Program. The report also authorized \$234 million for F/A-18 C/D fighter jets that was not included in the President's budget.

Research, Development, Test, and Evaluation

The research, development, test, and evaluation accounts are projected to increase by about \$10.9 billion during the 1997-2001 period. Additionally, increased purchasing power in these accounts due to the use of the lower inflation rate is projected at about \$6.5 billion. As mentioned earlier, about \$10.4 billion was transferred from the procurement accounts. As a result of the transfer in programs and other adjustments, intelligence and classified programs experienced the most growth. Our analysis shows that the largest increase is in advance development activities, which increased about \$3 billion per year over 1996 FYDP projections.

The National Defense Authorization Act for fiscal year 1997 authorized the addition of about \$2.6 billion more than the President's budget for research, development, test, and evaluation. The largest portions of the increase went to missile defense programs.

Military Construction

The 1997 FYDP projects that funding for military construction will increase by about \$1.5 billion over the 1997-2001 period compared to the 1996 FYDP. One reason for the increase is that the 1996 FYDP projected savings based on interim base closing plans that subsequently changed, and actual closing costs were higher. Specifically, compared to the 1996 FYDP, the 1997 FYDP reflects spending increases in military construction expenditures of about \$2.7 billion. The increase also reflects the transfer of some environmental restoration funds to the military construction account for cleanup at specific bases scheduled for closing.

Family Housing

DOD considers family housing a priority. Nonetheless, when compared to the 1996 FYDP, the 1997 FYDP shows that the family housing accounts will decrease by about \$1.8 billion. Improvements and other new construction are projected to decrease by about \$1.3 billion during 1997-2001. Current family housing plans include improvements to 4,100 housing units, construction or replacement of 2,300 units and 13 support facilities, and the provision of \$20 million for private sector housing ventures.

Agency Comments and Our Evaluation

We received comments on this report from OMB and DOD. DOD generally agreed with our report and offered some points of clarification, which we have incorporated where appropriate. OMB indicated that the change in inflation is important in forecasting the cost of the FYDP, not the level of inflation. Our review indicated, however, the level of inflation was also important because DOD makes its cost projections based on OMB guidance that specifies a level of inflation, not the rate of change. OMB and DOD comments are published in their entirety as appendixes II and III, respectively.

Scope and Methodology

To evaluate the major program adjustments in DOD's fiscal year 1997 FYDP, we interviewed officials in the Office of Under Secretary of Defense (Comptroller); the Office of Program Analysis and Evaluation; the Army, Navy, and Air Force budget offices; CBO; OMB; and BEA. We examined a variety of DOD planning and budget documents, including the 1996 and 1997 FYDPS and associated annexes. We also reviewed the President's fiscal year 1997 budget submission; our prior reports; and pertinent reports by CBO, the Congressional Research Service, and others.

To determine the implications of program changes and underlying planning assumptions, we discussed the changes with DOD, CBO, OMB, and BEA officials. To verify the estimated increased purchasing power in major DOD accounts due to revised estimates of future inflation, we calculated the annual estimated costs for each 1996 FYDP account using inflation indexes used by DOD from the National Defense Budget Estimates for fiscal years 1996 and 1997. The increased purchasing power was the difference between these calculated costs estimates and the reported 1996 FYDP account costs.

Our work was conducted from April through November 1996 in accordance with generally accepted government auditing standards.

We are providing copies of this report to other appropriate Senate and House Committees; the Secretaries of Defense, the Air Force, the Army, and the Navy; and the Director, Office of Management and Budget. We will also provide copies to others upon request.

If you have any questions concerning this report, please call me on (202) 512-3504. Major contributors to this report are listed in appendix IV.

A handwritten signature in cursive script that reads "Richard Davis".

Richard Davis
Director, National Security
Analysis

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Abbreviations

BEA	Bureau of Economic Analysis
CBO	Congressional Budget Office
DOD	Department of Defense
FYDP	Future Years Defense Program
GDP	gross domestic product
OMB	Office of Management and Budget
TOA	total obligational authority

DOD's Planned Use of Increased Purchasing Power by Service

Dollars in millions

Service/procurement item	Fiscal year					1997-2001
	1997	1998	1999	2000	2001	
Army						
Base realignment and closure activities			\$438	\$348	\$145	\$931
Combat support equipment			425	440	450	1,315
M1A2 tank upgrade	\$49	\$68	89	91	93	390
M2A3 tank upgrade			156	413	481	1,050
Apache Longbow System				12	123	135
Javelin medium anti-tank weapon			196	413	384	993
Hellfire missiles	94	93	99	103	110	499
UH-60 Blackhawk	87	133	129	128	100	577
Wheeled vehicles	45		227	212	212	696
Paladin howitzer upgrade	109					109
Other programs	45	17	21	13	2	98
Subtotal	\$429	\$311	\$1,780	\$2,173	\$2,100	\$6,793
Navy and Marine Corps						
Amphibious transport (LPD)			880			880
Overhaul carrier				1,700		1,700
Guided missile destroyer (DDG-51)	100					100
F/A-18 E/F			100	480		580
USMC ground upgrade		100	100	200	160	560
Enhanced modular signal processor	4					4
AV-8B procurement acceleration			28			28
EA6B aircraft				72	72	144
Cooperative engagement	89					89
Precision-guided munitions			100	200	203	503
Subtotal	\$193	\$100	\$1,208	\$2,652	\$435	\$4,588
Air Force						
Expendable launch vehicles			133	228	134	495
F-22 advanced tactical fighter			50	88	194	332
Precision-guided munitions			24	52	66	142
F-15/16	274					274
Tactical aircraft modifications			250	260	250	760
Subtotal	\$274	0	\$457	\$628	\$644	\$2,003
Total	\$896	\$411	\$3,445	\$5,453	\$3,179	\$13,384

Source: Department of Defense.

Comments From the Office of Management and Budget

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

November 8, 1996

Richard Davis
Director, National Security Analysis
General Accounting Office
Washington, D.C. 20548

Dear Mr. Davis:

I would like to thank you and your staff for the opportunity to work with you on the GAO report on defense spending and inflation.

I have only a few suggestions on the draft "Future Years Defense Program: Lower Inflation Outlook Was Most Significant Change From 1996 to 1997 Program" that accompanied your letter of October 28, 1996, addressed to the Director.

1) On page 5, second paragraph: Suggest adding a parenthetical second sentence (i.e., immediately after the designation of footnote 4):

(Estimates of the FYDP in any given year build in anticipated future inflation. Therefore, it is changes in anticipated inflation, rather than the levels of inflation, that affect the projected cost of the FYDP.)

2) On page 6, second paragraph, first sentence: Suggest replacing the phrase that states the implicit GDP price deflator has been used to adjust "...many government purchases of goods and services for budgetary purposes." The implicit price deflator for GDP has not been applied Government-wide. The sentence should read:

For more than a decade, OMB has used projections for the Commerce Department's Bureau of Economic Analysis' (BEA) implicit price deflator for Gross Domestic Product (GDP) based on a "fixed weighted" methodology to adjust the future costs of defense nonpay purchases other than fuel.

3) Again on page 6: Suggest that you change the following sentence to:

According to OMB officials, anecdotal information for recent years suggests that changes in this measure have been an accurate gauge of changes in costs of DOD purchases.

4) On page 8, line 6: Suggest that you change "has" to "could have."

5) On page 8, line 8: Suggest omitting the sentence that reads

For example, had DOD applied the new chain-weighted inflation assumption of 2.7 percent in developing its 1997-2001 FYDP rather than the 2.2 percent assumed inflation in the implicit deflator for GDP based on fixed weights, our analysis shows that DOD's increased purchasing power would be only about \$13 billion, not \$34.7 billion.

Now on pp. 2 and 4.

See comment 1.

Now on p. 4.

See comment 2.

Now on p. 4.
See comment 2.

Now on p. 5.
See comment 3.

Now on p. 5.
See comment 4.

**Appendix II
Comments From the Office of Management
and Budget**

The GAO calculation of \$13 billion does not use a consistent measure of inflation when estimating the effect of a change in the inflation outlook on real purchasing power. OMB believes that the use of a consistent measure is essential. The calculation compares the 3.0 percent inflation forecast using the GDP implicit price deflator in the 1996 Budget with the 2.7 percent inflation using the chain-weighted GDP price index in the 1997 Budget. This comparison is inappropriate because these measures are inconsistent. The OMB estimate of \$34.7 billion is correctly based on the change in inflation measured by one consistent standard -- the pre-benchmark revision GDP implicit price deflator -- in the 1996 Budget (3.0 percent) and in the 1997 Budget (2.2 percent). The previous sentences in the paragraph correctly describe the need to use consistent inflation measures.

If you believe that it is important to present that calculation despite the argument that the use of inconsistent measures from one year to the next introduces an error to the measurement, I would ask that you add the following sentence at the end of the carryover paragraph from page 7 to page 8:

However, OMB officials contend that the repricing of the FYDP should use the change in a consistent measure of inflation -- that is, either fixed-weight to fixed-weight, or chain-weight to chain-weight. This reflects the fact that it is changes in inflation, under a consistent measure, that determine the change in the cost of the FYDP. Under the OMB forecast, the two inflation measures declined by the same amount, yielding about the same change in the price of the FYDP regardless of which measure is used.

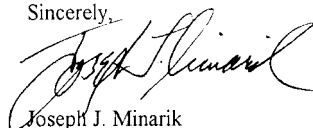
6) On page 8, the carryover paragraph from page 8 to page 9, line 9: Suggest that you change "will likely" to "could."

7) On page 9, the carryover paragraph from page 8 to page 9, last sentence: Suggest that you change to:

Whether such additional funds would actually be required to finance planned expenditures would be dependent on whether changes in the old fixed-weight based or in the newer chain-weight based inflation measure more closely tracks changes in the prices of DOD purchases.

Thank you for your consideration of these comments. I would be happy to discuss them with you or your staff. I can be reached at (202) 395-5873.

Sincerely,



Joseph J. Minarik
Associate Director
for Economic Policy

Now on p. 5.

See comment 2.

See comment 5.

The following are GAO's comments on the Office of Management and Budget's (OMB) letter dated November 8, 1996.

GAO Comments

1. We agree with OMB that estimates of the Future Years Defense Program (FYDP) in any given year include anticipated future inflation and that changes in anticipated inflation affect the projected cost of the FYDP. We have made this more explicit in our report. However, the levels of forecasted inflation are also important to project future costs. As we explain in this report, the Department of Defense (DOD) projects costs based on OMB guidance that specifies an annual level of inflation for the FYDP period, not the changes in forecasted inflation.
2. The report was amended to reflect this comment.
3. As explained in comment 1, DOD projects costs based on the forecasted inflation rates it receives from OMB. Therefore, we believe the forecasted inflation rates have a direct impact on DOD's estimated future funding requirements.
4. Our example is meant to show how application of a specific inflation rate to the FYDP can affect assumed purchasing power. As we explained previously, we believe the projected costs of the FYDP are affected not only by the change in inflation rates but also by the level of inflation. OMB asserts that under its forecast, the two inflation measures declined by the same amount. However, the Analytical Perspectives of the Budget for Fiscal Year 1997 shows a smaller decrease in inflation under the chain-weighted methodology—5/10 of 1 percent compared to 8/10 of 1 percent under the fixed-weighted methodology. Therefore, use of the changes in either methodology consistently would not have yielded the same change in the price of the FYDP.
5. The sentence was deleted from the final report.

Comments From the Department of Defense



PROGRAM ANALYSIS
AND EVALUATION

OFFICE OF THE SECRETARY OF DEFENSE
1800 DEFENSE PENTAGON
WASHINGTON, D. C. 20301-1800



NOV 1996

Mr. Richard Davis
Director, National Security Analysis
National Security and International Affairs Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Davis,

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "Future Years Defense Program: Lower Inflation Outlook Was Most Significant Change from 1996 to 1997 Program," October 28, 1996 (GAO Code 701090/OSD Case 1222). The Department generally concurs with the report subject to the following points of clarification.

The report addresses the accuracy of the price index on which the Department projected spending levels in the FYDP. The Office of Management and Budget (OMB) calculated the Gross Domestic Product (GDP) deflator which the DoD and other federal agencies used to project non-pay purchases just as it had in previous budgets, using a fixed-weight method (i.e., one that assumes a stable composition of goods and services in the economy). The fixed-weight GDP deflator was the measure of inflation in general use and acceptance by OMB when DoD prepared its FY 1997 budget. Subsequently, the *Economic Report of the President* published a new index of inflation calculated using an improved method that reflects shifts from one year to the next in assumptions about the composition of goods and services in the economy. The OMB has indicated its intention to adopt this chain-weighted index for budgeting beginning with the FY 1998 submission, and the Department will implement this transition when it updates the economic assumptions it uses to complete its FY 1998 budget and FYDP. Any of the forecasts cited in the report would change the price index for DoD's purchases of most goods and services by an amount that is within the range that is typical from one year to the next.

To appreciate fully the significance of any changes in these forecasts, it also is important to understand that the price index for non-pay purchases is not the only factor which determines whether projected budgets are sufficient to buy the planned program. Of equal importance is the size of the comparability increases planned for military and civilian pay and the budget authority OMB allocates to DoD. It is the interaction of all four factors that determines how the Department would accommodate a change in the inflation forecast, and the report's discussion of the magnitude and direction of prospective funding adjustments should be viewed in this light.

The report also addresses the prospects for achieving a level of procurement funding sufficient to modernize the Bottom-Up Review force structure. As explained in the report, the nominal changes to procurement between the FY 1996 and FY 1997 FYDPs are almost entirely

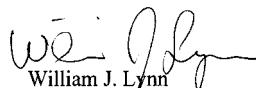


Appendix III
Comments From the Department of Defense

accounted for by lower inflation (\$15.3 billion) and an explicit reclassification of intelligence programs from the procurement to the research, development, test, and evaluation (RDT&E) appropriations (\$10.4 billion). The real (inflation-adjusted) reduction to the content of modernization programs planned the previous year is only \$300 million over five years.

Finally, the report addresses the viability of the Department's plans to increase funding for procurement with savings from streamlining the defense infrastructure. While the FYDP projects the nominal dollars allocated to infrastructure will grow, the real size of the DoD infrastructure will be shrinking, both in absolute terms and relative to the DoD budget. The \$155 billion in FY 2001 cited in the report represents a real decline of about \$5 billion from the FY 1997 level. As a proportion of the total DoD budget, \$155 billion will consume 57%, three percent less than the 60% portion that infrastructure activities are consuming in FY 1997. This relative reduction will free-up about \$7 billion of the \$270 billion topline planned for the last year of the FYDP. Reallocating these savings to procurement would contribute more than a third of the amount necessary to fulfill the FYDP's plan to increase real procurement 40% by FY 2001. A part of those savings are expected to accrue from closing and realigning military bases. In this regard, the report correctly identifies a change in the net savings that will accrue through FY 2001 from the Base Realignment and Closure (BRAC) process. Accordingly, because the FY 1996 FYDP was submitted before the 1995 BRAC Commission issued its recommendation to close or realign 132 additional bases, their complete costs and savings could not have been known until preparation of the FY 1997 FYDP.

The Department appreciates the opportunity to comment on the draft report.


William J. Lynn
Director

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Related GAO Products

Defense Infrastructure: Costs Projected to Increase Between 1997 and 2001 (GAO/NSIAD-96-174, May 31, 1996).

Defense Infrastructure: Budget Estimates for 1996-2001 Offer Little Savings for Modernization (GAO/NSIAD-96-131, Apr. 4, 1996).

Future Years Defense Program: 1996 Program Is Considerably Different From the 1995 Program (GAO/NSIAD-95-213, Sept. 15, 1995).

DOD Budget: Selected Categories of Planned Funding for Fiscal Years 1995-99 (GAO/NSIAD-95-92, Feb. 17, 1995).

Future Years Defense Program: Optimistic Estimates Lead to Billions in Overprogramming (GAO/NSIAD-94-210, July 29, 1994).

DOD Budget: Future Years Defense Program Needs Details Based on Comprehensive Review (GAO/NSIAD-93-250, Aug. 20, 1993).

Transition Series: National Security Issues (GAO/OCG-93-9TR, Dec. 1992).

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